BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
DELTA CESSPOOL AND SEPTIC)
TANK SERVICE, IMC.)

Appearances:

For Appellant: Frank C. Scott, Certified Public Accountant

For Respondent: Israel Rogers, Assistant Counsel

O P I N I O N

This appeal is made pursuant to Section 25667 *of* the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of Delta Cesspool and Septic Tank Service, Inc., to proposed assessments of additional franchise tax in the amounts of $156, $156, $263.86, $144.91 and $33.60 for the taxable years 1953, 1954, 1955, 1956 and 1956, respectively, based upon income for the years 1953, 1954 and 1955.

The question presented is whether certain amounts paid to, or on behalf of, Appellant's sole stockholder should be allowed as deductions for business expenses within former Section 24121a of the Revenue and Taxation Code and present Section 24343. Section 24121a included the following expenses as deductible:

> All the ordinary and necessary expenses paid or incurred during the income year in carrying on business, including a reasonable allowance for salaries or other compensation for personal services actually rendered . . . .

Section 24343 contains similar language.

Appellant, a California corporation with only nominal invested capital, was engaged in servicing cesspool and septic tanks. The only books kept *were* records of cash receipts and disbursements, records of amounts payable by customers and certain payroll records.

Appellant never paid a formal dividend. Its president and sole shareholder, Perry 0. Warthan, devoted his full time to the business and also allowed Appellant use of his equipment and machinery. Management was solely conducted by him. No directors' or stockholders* meetings were held at which his compensation was

fixed or at which rent was established for the equipment. Warthan received $50 a week plus a bonus at the end of each year. Warthan also withdrew funds from Appellant to pay his personal expenses and Appellant also directly paid some of Warthan's personal expenses.

On its franchise tax returns, Appellant deducted as officer's salary $9,900, $16,000 and $14,000 for the income years 1953, 1954 and 1955, respectively. Respondent Franchise Tax Board allowed all these amounts except $1,320.47 of the deduction claimed for the year 1954. This sum was disallowed on the ground that it was not paid. Also disallowed were certain other items claimed on Appellant's franchise tax returns as attorney fees, interest expense, taxes and licenses, and other miscellaneous expenses. These items *were* actually personal expenses of Warthan, now alleged by Appellant to represent additional deductible compensation. These amounts were some or all of the withdrawals and direct payments for Warthan's personal expenses to which reference was made above. Respondent has treated the disallowed items as in the nature of dividends to Warthan.

Respondent maintains that the disallowed payments were not actually intended as, and therefore did not actually constitute, compensation for services rendered. Respondent asserts that only the amounts deducted as salary on the returns were intended as such.

Appellant disagrees, urging that the only question should be whether the amount claimed is a reasonable amount of compensation for Warthan's services.

Income tax deduction is a matter of legislative grace and the burden of clearly showing the right to the claimed deduction is imposed upon the taxpayer. (Interstate Transit Lines v. Commissioner, 319 U.S. 590 [87 L. Ed. 1607]; Deputy v. DuPont, 308 U.S. 488 [84 L. Ed. 416]; New Colonial Ice Co. v. Helvering, 292 U.S. 435 [78 L. Ed. 1348]; Mississippi River Fuel Corp. v. Koehler, 266 F.2d 190, cert. denied, 361 U.S. 827 [4 L. Ed. 2d 70].)

The deduction on Appellant's returns of certain amounts as officer's salary, while deducting other amounts under other headings on the returns, indicates that only amounts deducted as salary were intended to be compensation for Warthan's personal services. The corporation books do not lend Appellant any evidentiary support. In fact, no corporate action of Appellant evidences that payment by Appellant of amounts in excess of that claimed as salary on the returns was payment of compensation. The corporate action as to the excess was just as consistent with payments of amounts in the nature of dividends or in the nature of gifts.

In a substantially similar situation the United States Board of Tax Appeals refused to allow the deduction claimed by a taxpayer (Appeal of Bonner Springs Lodge and Sanitarium Co., 3 B.T.A. 1151A). See also, Challenge Manufacturing Co., 37 T.C. No. 65; King, Quirk & Co., T.C. Memo., Dkt. No. 72395, Sept. 2% 1961.) Furthermore, in Zenith Sportswear Co., 28 T.C. 455, taxpayer claimed a refund based on a deduction for salary allegedly paid to a retiring stockholder. The taxpayer did not accrue on its books or claim on its return any salary for the stockholder for the taxable year in question. The court concluded that the parties never intended a salary payment because it was not accrued on the corporate books and never paid as salary.

At the hearing Appellant argued that the case of Commissionar v. R. J. Reynolds Tobacco Co., 260 F.2d 9, is authority for the proposition that the designation made by the corporation of the nature of the payment is immaterial. The court there stated that "Those payments which were intended to and did in fact compensate for services actually rendered are deductible; the rest are not." In that case, sometimes the Board resolutions referred to the payment as compensation and the record otherwise indicated that an employee-incentive compensation plan was involved. This is indicated in the findings and opinion of the lower court, T. C. Nemo., Dkt. No. 45432, July 6,1956. On the other hand, in Appellant's case there is no evidence to establish that any payments exceeding the salary deducted on the returns was intended as compensation for services.

A question remains with respect to the amount of $1,320.47 which was disallowed by Respondent for the income year 1954 on the ground that it was not paid. Since the total of the items disallowed for that year as having been paid to Warthan or on his behalf substantially exceeded $1,320.47, the latter amount was necessarily also paid to him or on his behalf. According to Respondent's own argument, Appellant intended the sum of $16,000 as compensation to Warthan for 1954, and Respondent concedes that such amount is reasonable compensation. In our opinion the entire $16,000, including the questioned sum of $1,320.47, is deductible from income for the year 1954.

In the course of its argument, Appellant has intimated that some deduction should be allowed for rental of its shareholder's equipment. We cannot do this, however, since there is no evidence of any intent to pay rent in addition to the amounts paid as salary.

We conclude that, except for the amount of $1,320.47 related to the income year 1954, all of the deductions in question were properly disallowed,

Appeal of Delta Cesspool and Septic Tank Service, Inc.

O R D E R

Pursuant to the views expressed in the opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to Section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests of Delta Cesspool and Septic Tank Service, Inc., to proposed assessments of additional franchise tax in the amounts of $156, $156, $263.86, $144.91 and $33.60 for the taxable years 1953, 1954, 1955, 1956 and 1956, respectively, be modified by allowing a salary deduction of $16,000 from income for the year 1954, in accordance with the opinion on file herein. In all other respects the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 19th day of &larch, 1963, by the State Board of Equalization.

John W. Lynch, Chairman

Geo. R. Reilly, Member

Paul R. Leake, Member

Richard Nevins, Member

_____, Member

ATTEST: Dixwell L. Pierce, Secretary